CHAPTER 19

Transfer Taxation

The Treasury Department proposals relating to the estate, gift, and generation-skipping transfer taxes are designed to continue the process begun in 1976 of integrating these taxes into a unified system. To this end, the proposals would impose the gift tax on a tax-inclusive basis, would revise the rules governing when a transfer is complete for gift tax purposes, would revamp the generation-skipping transfer tax, and would revise the credit for tax on prior transfers consistently with the theory of the generation-skipping transfer tax.

The proposals also include a number of reforms to simplify the transfer taxes and curtail abuses and inequities. New valuation rules would apply to transfers of fractional interests in property; the rules for payment of estate tax in installments would be simplified and liberalized; the state death tax credit would be replaced with a flat-rate credit; the estate tax deduction for interest as an administration expense would be denied; and the powers-of-appointment rules would be revised. Finally, coordination with the income tax would be advanced by revising the rules relating to income and deductions in respect of a decedent, and repealing the special rules for redemption of stock to pay death taxes.

UNIFY ESTATE AND GIFT TAX SYSTEMS

General Explanation

Chapter 19.01

Current Law

In General. Under current law, the estate tax and the gift tax (referred to collectively as transfer taxes) are imposed using the same graduated rate structure. Under this unified rate structure, the marginal transfer tax rate applicable to any taxable transfer is determined by taking into account all prior transfers, whether made during lifetime or at death. Current law also provides a unified transfer tax credit, which is used to offset the transfer tax payable by a donor or a decedent's estate. The unified credit is being phased in gradually and will reach $192,800 in 1987; at that time, the credit will effectively exempt from transfer tax liability the first $600,000 in otherwise taxable transfers made by an individual.

The purpose of the single rate and unified credit structure is to ensure that the gift tax fulfills its function as a backstop to the estate tax; that is, gifts are subject to tax at the same rate and are treated like transfers at death for purposes of the unified credit. Unification of the gift and estate taxes is designed to ensure that taxes are a relatively neutral factor in an individual's decision whether to make a lifetime gift. In addition, since wealthier individuals are more likely to be financially able to make substantial lifetime gifts, taxing lifetime transfers and transfers made at death in the same manner helps to ensure fairness and progressivity in the overall transfer tax system.

Although imposed at the same nominal rate as the estate tax, the gift tax is not imposed on the same tax base as the estate tax. The estate tax is imposed on the entire amount of the taxable estate, with no deduction or exclusion from the base for the portion of the estate that goes to pay the tax. Because the estate tax base includes the amount used to pay the tax, the estate tax is said to be imposed on a "tax-inclusive" basis. In contrast, the gift tax is imposed on a "tax-exclusive" basis (i.e., only the amount of property that actually passes to the donee is subject to tax). In addition, the first $10,000 transferred to each donee during a taxable year is excluded from the gift tax base.

Completion of Gift. Present law contains a complex set of rules governing when a transfer is complete for purposes of applying the gift tax. In general, these rules provide that a gift will not be complete unless the donor has so parted with dominion and control over the property that he or she no longer possesses any power to change its disposition, whether for the donor or another.

Transfers within three years of death. Any gift tax paid with respect to a gift made within three years of a decedent's death will be included in the decedent's gross estate for Federal estate tax purposes. In the case of a transfer by the decedent of the incidents of ownership of a life insurance policy on the life of the decedent within three years of death, the amount includible in the decedent's estate will be the proceeds of the policy rather than its value at the time of the gift. In effect, these rules cause any taxable gifts made within three years of the donor's death to be subject to tax on a tax-inclusive basis, as if the property had been retained by the donor until his death (although post-gift appreciation is not brought back into the donor's gross estate).

The Retained Interest Rules. Because of the preferential tax treatment afforded to transfers by gift, the role of the gift tax as a backstop to the estate tax can be fully realized only if rules exist that prevent the structuring of a testamentary transfer in a form that qualifies such transfer for gift tax treatment. When applicable, the retained interest rules require the full date-of-death value of the transferred property (offset by any consideration received by the decedent on the initial transfer) to be included in the donor's estate. Such value will thus be subject to tax on a tax-inclusive basis, although a credit is given for any gift tax paid at the time of the original conveyance of the property. The most important of these rules are described briefly in the following paragraphs.

Transfers with retained beneficial enjoyment. There must be included in a decedent's gross estate the date-of-death value of any property transferred during his lifetime by gift if the decedent retained for his lifetime possession or enjoyment of the property or the right to the income from the property. This estate tax rule applies even though the decedent reported the underlying transfer as a taxable gift and paid a gift tax on all or a portion of the value of the property.

Transfers with retained control. A decedent's gross estate includes the fair market value of property previously transferred by gift where the decedent has retained for his lifetime "the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom," or "a power . . . to alter, amend, revoke, or terminate" the transfer. As a practical matter, these two inclusion rules often provide overlapping coverage.

The premise of these two provisions is that the power to determine the ultimate recipient of the property, or to control the time or manner of enjoyment of the property by the recipient, is a sufficient ownership interest in the property to cause it to be treated as if owned by the transferor. Thus, these provisions can apply even though the retained power did not give the decedent the power to revoke the transfer or otherwise to revest title in himself.

Reversionary interests. Also included in the decedent's gross estate is the value of any interest in property with respect to which the decedent has previously made a transfer and has retained a proscribed reversionary interest. This rule applies only if the value of the decedent's reversionary interest immediately before the death of the decedent exceeds five percent of the value of the property.

Reasons for Change

Notwithstanding the policies supporting full unification of the estate and gift taxes, significant tax incentives remain for individuals to make lifetime gifts. Arguably, some of these tax advantages are justifiable because of practical considerations. For example, the $10,000 annual exclusion from gift tax is often justified as a threshold for application of the tax because of the compliance and administrative problems that otherwise would be created. The application of the same progressive rate schedule to all transfers, without adjustment for post-transfer appreciation in the value of the property, may also be justified because of simplicity and because a lifetime transfer deprives the donor of the use of the property and the use of any money used to pay gift tax on the transfer.

On the other hand, some of the advantages of lifetime gifts cannot be justified either on grounds of tax policy or administrative convenience. Specifically, neither tax policy concerns nor administrative convenience support application of the gift tax on a tax-exclusive basis while the estate tax is computed on a tax-inclusive basis. Such a rule hampers the overall fairness of the transfer tax system because the individuals it benefits are those who can afford to give away a significant portion of their property during life. Those individuals who are unable or unwilling to make lifetime gifts, and who therefore retain their property until death, are subject to tax at a higher effective rate.

In addition, the preferential treatment accorded lifetime gifts encourages individuals to make lifetime transfers solely to reduce their overall transfer tax burden. The transfer tax system should not treat an individual wishing to retain his or her property until death either more or less favorably than it treats an individual wishing to make lifetime gifts.

Finally, the preference given lifetime gifts has resulted in a complex and often arbitrary set of rules that attempt, with uneven results, to prevent taxpayers from taking unintended advantage of the preference. In some cases, these rules do not fully remove the preference given to lifetime gifts; in others, the rules are punitive and cause transfer tax consequences that are more severe than if the individual had not made a lifetime gift.

Proposal

Unification of gift and estate taxes

The gift tax would be computed on a tax-inclusive basis. Under this system, the gift tax payable on a transfer of a fixed net amount to a donee would be determined by calculating the gross amount that, when subject to the transfer tax rate schedule, would be sufficient to pay the gift tax on the transfer and leave the net amount for the donee. Stated differently, the amount of the gift would be "grossed up" by the amount of the gift tax payable with respect to the transfer. The tax imposed on a decedent's estate would be computed by adding the amount of the decedent's taxable estate to the sum of the decedent's adjusted taxable gifts and the gift tax paid by the decedent.

In order to prevent taxpayers from having to make somewhat complicated gross-up calculations, the gross-up factor would be built into the rate table contained in the statute. Under this method, the stated rate applicable to gifts would be higher than the stated rate applicable to estates, but the effective rate imposed on a net transfer would be the same regardless of whether subject to the gift tax or the estate tax. Assuming that the rates of present law remain in effect, and that the 50 percent maximum effective transfer tax rate and the $600,000 credit-equivalent are fully phased in, the gift tax rates would be as set forth in Table 1.

Table 1

Gift Tax Rates Imposed on Tax-Inclusive Basis

Net Amount Transferred	Tax Payable After Credit
0 - $600,000	0
over $600,000 but not over $694,500	58.73 percent of amount over $600,000
over $694,500 but not over $847,000	$55,500 plus 63.93 percent of amount over $694,500
over $847,000 but not over $994,500	$153,000 plus 69.49 percent of amount over $847,000
over $994,500 but not over $1,137,000	$255,500 plus 75.44 percent of amount over $994,500
over $1,137,000 but not over $1,412,000	$363,000 plus 81.82 percent of amount over $1,137,000
over $1,412,000 but not over $1,667,000	$588,000 plus 96.08 percent of amount over $1,412,000
over $1,667,000	$833,000 plus 100 percent of amount over $1,667,000

Simplification of Rules Pertaining to Completed Gifts and Testamentary Strings

Application of the gift tax on a tax-inclusive basis would eliminate the major disparity between the transfer tax treatment of lifetime gifts and transfers at death. Therefore, it would be possible to eliminate the rule requiring inclusion in the gross estate of gift taxes paid on transfers made within three years of death. The complex retained interest rules would be replaced with a simpler set of rules determining when a transfer of less than an entire interest constitutes a completed gift for Federal transfer tax purposes. These new rules would ensure that a transfer is subject to gift or estate tax, but not to both taxes. In addition, the rules would assure a more accurate valuation and provide greater consistency between the transfer tax rules and the rules governing when trust income is taxed at the grantor's rate.

Retained beneficial enjoyment. The proposal would simplify present law by providing that a transfer tax would be imposed only once, when the beneficial enjoyment retained by the donor terminates. Thus, if a donor makes a gift of a remainder interest in property, but retains the intervening income interest, no gift would occur until the termination of the donor's income interest. At that time, the property would be subject to gift or estate tax at its full fair market value. Because the transferor would be treated as the owner of the property during the interim, any distributions made to beneficiaries other than the transferor would be treated as transfers when made.

The transferor would continue to be treated as owner of the property for all transfer tax purposes. Such treatment would foreclose any opportunity for tax avoidance through the transferor's repurchase of the remainder interest free of gift tax.

The proposal would also apply to the creation of inter vivos charitable lead trusts. The creator of such a trust would be treated as owning the property for transfer tax purposes until the vesting of the non-charitable interest or his or her death, if sooner. (Testamentary charitable lead trusts would be taxed as under present law.)

Revocable transfers. The rules of present law would continue with respect to any transfer where the transferor retains the right to regain possession or enjoyment of the property. Such a transfer would be treated as incomplete for gift and estate tax purposes, and would be treated as complete only when the transferor's retained right or power to revoke terminates. Distributions from the property to beneficiaries other than the donor would be treated as gifts when made, thereby providing consistency with the rules governing the income taxation of trusts as well as the rules governing the income and gift tax treatment of demand loans.

Retained powers. In determining whether a gift is complete for transfer tax purposes, the proposal would treat a retained power to control the beneficial enjoyment of the transferred property as irrelevant where the power could not be used to distribute income or principal to the donor. Thus, the fact that the transferor as trustee or custodian can exercise control over the identity of the distributee of the property or over the amount or timing of a distribution would be irrelevant in determining whether a gift is complete (although such factors may be relevant in determining whether the transfer qualifies for the annual gift tax exclusion). Under this rule, a transfer would be complete for gift tax purposes where the grantor creates an irrevocable trust but retains the absolute right to determine who (other than himself) will receive the trust income or principal.

Reversionary interests. Current rules regarding retained reversionary interests would be replaced by a rule that disregards reversionary interests retained by the grantor in valuing transferred property for Federal gift tax purposes. The existence of the reversionary interest would be relevant only for purposes of determining the timing of the transfer for estate and gift tax purposes.

If the donor makes a gift of property for a term of years or for the life of one or more beneficiaries, and if the donor retains a reversionary interest that is more likely than not to return the property to the donor or his or her estate, the transfer would be treated as incomplete. Interim distributions of income or principal (or the value of the use of the property) would be treated as gifts by the donor on an annual basis. On the other hand, if it is more likely than not that the reversionary interest will not return the property to the donor or his or her estate, the transfer will be treated as complete and the full fair market value of the property will be subject to gift tax, without reduction for the actuarial value of the reversionary interest. If the donor dies with the reversion outstanding, the value of the reversionary interest will be excluded from the donor's estate, whether or not the reversion terminates at that time. If the property reverts to the donor prior to his or her death, the donor would have the right to retransfer the property at any time free from additional gift tax liability. If not retransferred during the donor's lifetime, the property would be excluded from the donor's estate. In order to prevent disputes arising from the reversion and subsequent retransfer of fungible assets, however, the proposal would require the donor to place the reverted property in a segregated account in order to benefit from the exclusion.

The determination of whether a reversionary interest is more likely than not to return property to the donor during his lifetime generally would depend on the life expectancy of the donor and the anticipated duration of the intervening interest. For example, a reversion following a term of years less than the donor's life expectancy or following the life of a beneficiary older than the donor would be more likely than not to return the property to the donor. Similar actuarial determinations would be made for multiple intervening income beneficiaries. These rules are the same as those that would apply in determining whether a trust that may revert to the grantor is entitled to an income tax deduction for distributions (or whether trust income is taxed at the grantor's rate). See Chapter 3.25.

Effective Dates

The proposal would apply generally to lifetime transfers made on or after January 1, 1986. For this purpose, any transfer that is revocable on the effective date would be treated as occurring when it becomes irrevocable. In addition, the gift tax paid with respect to post-1976 gifts made prior to the effective date would be included in the decedent's adjusted taxable gifts solely for the purpose of determining the transfer tax rate applicable to the decedent's estate.

With respect to transfers occurring on or after January 1, 1986, gifts made before 1986 with respect to the same property would be subject to the following transition rules:

Retained Beneficial Enjoyment. If prior to the effective date a donor has made an irrevocable transfer and has retained current beneficial enjoyment over the property, the proposal would apply and on termination of the donor's interest the full value of the property would be treated as a taxable transfer. Similarly, any interim distributions would be treated as taxable gifts when made. If the donor paid gift tax on the original transfer, he or she would have until the end of 1986 to claim a refund (with interest) of the tax paid. If the donor was required to file a gift tax return, but did not pay any gift tax on the original transfer because of the availability of the unified credit, the portion of the credit so utilized would be made available to offset tax liability on future transfers.

Reversionary Interests. The transition rule applicable to a pre-1986 irrevocable transfer with a retained reversionary interest would depend on whether the transfer would have been treated as a completed gift if made after the effective date. If the transfer would have been treated as incomplete because, at the time of the gift, the property was more likely than not to revert to the donor, and the property has not reverted to the donor at the time of his or her death, then the property would be included in the donor's estate at its fair market value on the date of his death. To avoid double taxation in such cases, the earlier transfer would not be included in computing adjusted taxable gifts and a credit would be available for any gift tax paid at the time of the original gift.

If the proposal would have treated the transfer as complete when made because the property was not likely to revert to the donor, the amount includible in the donor's estate would depend on whether the reversion was reflected in the value of the initial gift. If the full value of the property had been taxed at the time of the initial gift, with no reduction for the reversion, then no amount would be includible in the donor's estate by reason of the reversionary interest. On the other hand, if the donor discounted the value of the original gift to reflect the actuarial value of the reversionary interest, then the amount includible in the donor's estate would be the fair market value of the property at the time of his or her death multiplied by the percentage of the value excluded from the original gift by reason of the reversion.

Retained Controls. If the donor has made a pre-1986 transfer treated as an incomplete gift under present law, then the proposal would be fully applicable to such transfer as of the effective date. Thus, the relinquishment of the retained control, whether during lifetime or at death, would be treated as a taxable transfer. In addition, the donor would have until the end of 1986 to elect to treat the fair market value of the property on January 1, 1986 as a taxable gift (on a tax-inclusive basis) without relinquishing the retained control (assuming the donor has retained no other interest in the property); the making of such election would exclude any subsequent appreciation from the donor's transfer tax base.

459-813 0 - 84 - 14

If the pre-1986 transfer was treated as a partially completed gift when made, then the full value of the property would be subject to transfer tax when the retained control is relinquished, but a credit would be given for the gift tax previously paid and the prior transfer would be disregarded in computing the transferor's adjusted taxable gifts. As in the first case, the donor would have until the end of 1986 to elect to treat the fair market value of the property on January 1, 1986 as a taxable gift without relinquishing the retained control.

Finally, if the donor has previously made a transfer constituting a completed gift, so that the full value of the property subject to the power was subject to transfer tax, then the property would not be includible in the donor's estate (assuming the donor's death occurs on or after January 1, 1986).

Analysis

Application of the gift tax on a tax-inclusive basis would remove the primary tax incentive for lifetime gifts and therefore would make tax considerations a relatively neutral factor in the decision whether to dispose of property during one's lifetime or to retain it until death. Moreover, the proposal would provide greater fairness in the application of the transfer tax system because all persons paying the transfer tax would do so on the same tax-inclusive basis. Finally, by removing the major incentive for disguising testamentary transfers as lifetime gifts, the proposal would permit the simplification of the rules governing when a transfer is complete for estate and gift tax purposes.

The proposed rules for determining when a transfer is complete would ensure that each transfer is subject to estate or gift tax, but not to both taxes. By delaying the imposition of transfer tax liability until the donor's interest terminates, the proposed rules would reduce the number of instances in which it is necessary to consult an actuarial table to value the transfer of a partial interest in property and would provide greater accuracy in the valuation of the transferred interest.

Finally, the proposal would provide greater consistency between the gift tax rules governing when a transfer is complete and the rules governing when trust income is taxed at the grantor's rate.

It is anticipated that the proposal would result in a revenue increase in the year prior to the effective date because of an increase in the number of tax-motivated gifts designed to take advantage of present law. Because many donors are likely to accelerate gifts prior to the effective date, and because tax-motivated gifts would be greatly reduced by the proposal, gift tax collections should be lower in years after the effective date. On the other hand, since all transfers would be subject to tax on a tax-inclusive basis, the increase in estate tax revenues would eventually outweigh the decline in gift tax revenues; hence, the present value of total transfer tax collections would increase. Over time, this may permit some reductions in transfer tax rates; however, because the increase in estate tax revenues probably would not exceed the decline in gift tax revenues for a number of years, it is not possible to propose rate reductions at this time.

REVISE POWER OF APPOINTMENT RULES

General Explanation

Chapter 19.02

Current Law

A decedent's gross estate includes all property with respect to which the decedent possessed a "general power of appointment" at the time of his or her death. For purposes of this rule, the term "general power of appointment" is defined as a power given the holder by another (rather than a power created by the holder) enabling the holder to appoint the property to the holder or the holder's estate, or to creditors of either. The purpose of this rule is to include in a decedent's estate property with respect to which the decedent possessed virtually the same control as if the property were owned outright. Thus, a power will not be classified as a general power of appointment if it can be exercised only in conjunction with the creator of the power or in conjunction with a person having a "substantial interest" in the property that would be adversely affected by the exercise of the power of appointment. Moreover, a power will not be classified as a general power of appointment if the ability to exercise the power is limited by an "ascertainable standard" relating to the support, health, education, or maintenance of the holder.

Reasons for Change

The present rules governing general powers of appointment are largely ineffective. They can be circumvented easily by creation of a power that is purportedly limited by an ascertainable standard but that, in reality, gives the holder substantial discretion and control over the trust property.

In addition, present law can often trap the unwary taxpayer. For example, the general power of appointment rule may be invoked where neither the creator of the power nor the donee of the power is aware that a particular power is likely to be construed as a general power of appointment. To a great extent, this uncertainty exists because State law determines whether a limitation placed on the exercise of the power constitutes an "ascertainable standard." Thus, unless a standard is used that is identical with the language of the statute or the regulations, construction of the standard for Federal transfer tax purposes must generally await a construction of the language under State law.

Finally, the general power of appointment rule would in many cases be unnecessary if application of the generation-skipping tax would ensure that a transfer tax is collected at the decedent's generation. See Chapter 19.04, relating to modifications of the generation-skipping tax.

Proposal

The current power of appointment rules would be replaced by a rule treating an individual as the owner of property for transfer tax purposes where the individual possesses a nonlapsing right or power to vest the property or trust corpus in himself or herself. For purposes of this rule, a power or right would be treated as nonlapsing if it did not, by its terms, expire prior to the death of the powerholder.

The release of such a power (or the extinguishment of such a power at death) would be treated in the same manner as a transfer by the outright owner of the underlying property. Thus, for example, if the holder of a power releases the power and retains an income interest in the property which would cause a gift of the property to be treated as incomplete, he or she would continue to be treated as the owner of the property for Federal transfer tax purposes.

Effective Date

The proposal would apply generally to powers held by individuals dying after January 1, 1986, without regard to when the power was created. The proposal would also apply to powers that are exercised or relinquished by individuals on or after January 1, 1986, again without regard to when the power was created. Special rules would provide that property previously qualifying for the estate or gift tax marital deduction would be subject to transfer tax on the exercise or release of the power by, or on the death of, the transferee spouse.

Analysis

In general, the proposal would treat an individual as possessing a general power of appointment over property under circumstances similar to those in which the individual would be treated as the owner of trust property for Federal income tax purposes. Although a power of appointment might not result in the inclusion of property in the gross estate of the person holding the power, the property would potentially be subject to tax under the generation-skipping transfer tax rules.

The proposal would simplify the treatment of powers of appointment for Federal transfer tax purposes, and would make the transfer tax rules and the income tax rules more consistent. By eliminating the importance of determining whether an "ascertainable standard" exists or whether another person whose consent is required possesses an "adverse interest," the proposal would also remove some of the unexpected consequences that can arise from the creation of such a power.

REVISE FEDERAL GIFT TAX PROPERTY VALUE DETERMINATION

General Explanation

Chapter 19.03

Current Law

Property transferred by gift is valued for Federal gift tax purposes at its fair market value, in general the price it would bring in a transaction between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Thus, property transferred by gift is not valued by reference to the amount by which it increases the value of the donee's estate, nor is it valued by reference to the amount by which it decreases the value of the donor's estate.

Reasons For Change

In most instances, the value of property transferred by gift will be the same regardless of whether such value is determined by reference to the separate value of the property, the diminution in value of the transferor's estate, or the enhancement in value of the transferee's estate. In other instances, however, these measures of value can vary greatly. This is particularly true in the case of transfers of minority interests in closely held businesses and undivided interests in assets such as real estate. These interests are often valued, for transfer tax purposes, at significant discounts from their pro rata share of the value of the underlying business or asset.

For example, assume that A owns 100 percent of the outstanding stock of X, and that the value of A's stock in X is $1,500,000. If A transfers ten percent of the X stock to B, A may claim that for Federal gift tax purposes the value of the ten percent block of stock is as little as $90,000, reflecting a discount of as much as 40 percent from the proportionate share of the total value of the corporation. If A makes such gifts annually for six years, A may claim that the aggregate gift tax value of the 60 percent interest is only $540,000. Moreover, if A dies holding the remaining 40 percent block, A's estate may claim a minority discount on that stock. If those values are sustained, A has transferred stock worth $1,500,000, but for Federal estate and gift tax purposes has made transfers aggregating only $900,000.

Minority or fractional-share discounts enable taxpayers to structure transfers so as to reduce the aggregate value of property brought within the transfer tax base. This is inconsistent with the underlying purpose of the gift tax, which is to serve as a backstop for the estate tax. Moreover, the overall reduced value of the property as it is reported for transfer tax purposes is inconsistent with economic reality.

Proposal

The value for transfer tax purposes of a fractional interest in any asset owned, in whole or in part, by a donor or decedent would be a pro rata share of the fair market value of that portion of the asset owned by the donor or decedent. Prior gifts of fractional interests in the asset, as well as any fractional interests in the asset held by the transferor's spouse, would be attributed to the donor or decedent for purposes of determining the value of the fractional interest transferred. A fractional interest in an asset would include shares of stock in a corporation, partnership units, or similar interests in a single entity or asset. Rules would be provided to aggregate (or segregate) two different interests in property based upon the criterion of whether the ownership by the transferor of one such interest affects the valuation of the other such interest. For example, two publicly held classes of stock in a corporation generally would be valued independently.

This special valuation rule would apply to transfers of fractional interests, however, only if the donor retains a fractional interest after the gift or has previously made a gift of a fractional interest in the asset. This special valuation rule would also apply for purposes of determining whether a sale by the donor to a related party constitutes a transfer for less than an adequate and full consideration.

The proposal can be illustrated by the following examples.

Example. A owns 60 percent of the outstanding stock of a corporation worth $100x. A, whose controlling interest is worth $70x, transfers one-half of his interest to B. The value of the gift for gift tax purposes is $35x (i.e., 50 percent of the value of A's 60 percent block of stock). If A retains his remaining 30 percent block until his death, the estate tax value of such block will be 50 percent of the value of a 60 percent block of stock at the date of A's death.

Example. B owns 40 percent of the outstanding stock of a corporation worth $100x. B's minority interest is worth $30x, and B transfers one-half of her interest to A. The value of the gift to A would be $15x, i.e., 50 percent of the value of the 40 percent block possessed by B immediately prior to the gift. However, if B's spouse S owned stock representing 20 percent of the corporation, so that the combined interest of S and B was worth $75x, the value of the gift to A would be $25x, (i.e., 33-1/3 percent of the value of the 60 percent block held jointly by B and S).

The proposal would contain rules to prevent unfairness or abuse that could result from an individual's acquisition and subsequent transfer of a fractional interest in an asset after having made a gift of a fractional interest in the same asset.

Effective Date

The proposal would apply to transfers occurring and estates of decedents dying on or after January 1, 1986. In the case of donors who have transferred fractional interests in property prior to January 1, 1986 at a discount, the proposal would apply to any subsequent transfers of fractional interests in the same property without regard to the discounts obtained on the prior transfers. In those cases where a prior transfer of a fractional interest was valued at a premium, subsequent transfers of minority interests in the same property would be discounted by an appropriate factor to reflect the premium on the prior transfer. For example, if a donor owning all 100 shares of a corporation worth $100x transferred 60 of those shares prior to the effective date in a gift valued for Federal gift tax purposes at $75x, transfers of all or any of the remaining 40 shares after the effective date would be discounted by 37.5 percent. This ensures that if the total value of the corporation remains at $100x, the aggregate value of the remaining shares for transfer tax purposes would be $25x.

Analysis

By valuing fractional interests in property on the same basis regardless of whether such interests are transferred during lifetime or at death, the proposal would prevent the erosion of the transfer tax base through lifetime transfers aimed at artificially reducing the value of property. The proposal would support the full unification of the estate and gift taxes and would ensure that lifetime transfers are treated no more favorably than transfers at death.

SIMPLIFY GENERATION-SKIPPING TRANSFER TAX

General Explanation

Chapter 19.04

Current Law

As part of the Tax Reform Act of 1976, Congress enacted a new tax on certain generation-skipping transfers. This tax, designed to be separate from but complementary to the estate and gift taxes, applies to generation-skipping transfers effected through "generation-skipping trusts" and "trust equivalents." A generation-skipping trust is one that has two or more generations of beneficiaries who belong to generations that are younger than the generation of the grantor of the trust. The tax is imposed when the generation-skipping transfer actually occurs and is substantially equivalent to the tax that would have been imposed if the property had actually been transferred outright to each successive generation.

The tax generally applies to transfers made after June 11, 1976. An exception is provided for transfers under irrevocable trusts in existence on June 11, 1976, other than transfers attributable to corpus added to such trusts after that date. Additionally, in the case of any decedent dying before January 1, 1983, the tax does not apply to transfers pursuant to the decedent's will (or a revocable trust that becomes irrevocable by reason of the decedent's death) if the will (or revocable trust) was in existence on June 11, 1976, and was not amended (except in ways that did not create, or increase the amount of, a generation-skipping transfer) at any time after that date.

Reasons for Change

The principal problems with the present generation-skipping transfer tax (GST tax) may be summarized as follows:

- **Scope** - Every trust, no matter how small, that has beneficiaries in two or more generations below the grantor is a generation-skipping trust subject to the provisions of the GST tax. Yet such trusts are found in even the simplest of wills, often drafted by general practitioners whose knowledge of the intricacies of the GST tax is necessarily limited.

- **Complexity** - The GST tax is extremely complex, primarily because the amount of tax depends on the identification of a "deemed transferor" and a calculation based on that individual's transfer tax profile. This makes the GST tax difficult to understand, even for tax practitioners who specialize in estate planning, and can be a major complicating factor in advising clients. The complexity of the current GST tax also makes it unduly difficult to administer.

- **Effectiveness** - Because of its numerous exceptions, the GST tax is ineffective against many generation-skipping arrangements. The wealthiest transferors can avoid the tax at the generation level of their children (and grandchildren) by layering, i.e., passing large portions of their wealth directly to their grandchildren (and great-grandchildren). Moreover, the present GST tax exempts distributions of income from generation-skipping trusts, thereby permitting a substantial amount of property to avoid the tax. Thus, in many cases the GST tax encourages taxpayers to adopt more complex estate plans that deviate further from their natural dispositive preferences.

- **Fairness** - The scope and ineffectiveness of the present GST tax are also sources of unfairness. Both factors discriminate in favor of the "super wealthy" as compared to families of more modest wealth. The wealthiest families are in a much better position to incur the cost of the highly sophisticated tax advice and administrative fees necessary to understand and exploit the present statute. Moreover, the wealthiest individuals can better afford to layer their estates in a manner that avoids the GST tax.

Proposal

On April 29, 1983, the Treasury Department released A Proposal to Simplify and Improve the Generation-Skipping Transfer Tax. A draft of statutory language to implement this proposal was released on November 9, 1983, with subsequent drafts released on January 6, 1984 and February 2, 1984. The proposal also formed the basis for H.R. 6260, a bill introduced in the 98th Congress on September 18, 1984. Treasury incorporates into its proposals for fundamental tax reform the April 29, 1983 GST tax proposal, with only one significant modification (discussed below).

The proposal would make three fundamental changes in the present GST tax system.

Exemption of $1,000,000 Per Grantor

First, every individual would be permitted to make transfers aggregating as much as $1,000,000, during lifetime and at death, which would be wholly exempt from the GST tax. This exemption would be freely transferable between spouses, so that a married couple would have an exemption of $2,000,000 without regard to which spouse makes the transfer.

Flat Rate Tax on Non-Exempt Transfers

Second, generation-skipping transfers not covered by the $1,000,000 exemption would be taxed at a flat rate equal to 80 percent of the highest estate tax rate in effect at the time of the transfer. This means that for taxable generation-skipping transfers after 1987, the tax rate would be 40 percent. The substitution of a flat rate for a tax computation based on the tax profile of a deemed transferor would be a major simplification over present law.

The difference between the current proposal and that of April 29, 1983 (alluded to above) is that under the current proposal the tax would be imposed uniformly on a "tax-inclusive" basis. This further simplification is made possible by the proposed change under which the gift tax would also be imposed on a tax-inclusive basis. See Chapter 19.01.

Taxation of All Generation-Skipping Transfers Not Covered by the $1,000,000 Exemption

Third, subject to the $1,000,000 exemption given each transferor and the other exclusions noted above, the proposal would apply a GST tax to property when all interests in the property are transferred to or held for the benefit of recipients at least two generations below that of the transferor without the payment of estate or gift tax in an intervening generation. Thus, the GST tax would apply immediately to outright transfers to any person two or more generations below the transferor and to any transfer in trust for the exclusive benefit of one or more such beneficiaries. However, transfers to trusts where a member of the grantor's generation or the generation of the grantor's children has an interest would not be subject to immediate tax. As under present law, the tax in that case would be postponed until actual distributions are made to lower generation beneficiaries or until all interests of the higher generation beneficiaries terminate, at which time the tax would be imposed on the value of the distributed property or the property remaining in the trust. Unlike the present GST tax, however, the proposed GST tax would not provide an exclusion for income distributions. Instead, an income tax deduction would be provided for the GST tax imposed on such income distributions.

Further details of this proposal may be found by consulting the April 29, 1983 proposal. Of course, the examples set forth at the end of that proposal must be modified to take into account the imposition of the tax on a tax-inclusive basis. See also Chapter 19.05, relating to the credit for tax on prior transfers.

Effective Date

In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts of decedents dying before the date which is one year from the date of enactment. The effective date would be extended for testators who are incompetent on the date of enactment. This one-year transition rule would give estate planners time to understand the new rules and to adjust their planning accordingly.

The existing tax on generation-skipping transfers would be repealed retroactively, so that no trust would ever be subject to the provisions of that tax.

Analysis

A transfer tax system without a GST tax is unfair. Without a GST tax the wealthiest families will pay a transfer tax on their accumulated wealth only once in every two or three generations. Families of more modest wealth may be reluctant or unable to enter into generation-skipping arrangements. This disparity greatly undermines the progressivity and equity of the Federal transfer tax system and, ironically, results in a system that taxes wealth that an individual has accumulated during his own lifetime more harshly than wealth that has been inherited.

Once the proposed GST tax becomes fully effective, transfer taxes should play a significantly reduced role in taxpayers' estate planning. Those taxpayers who wish to leave their property outright to their children would be free to do so, knowing that they are not missing a significant tax avoidance opportunity through the creation of a multi-generational trust or through direct transfers to grandchildren. On the other hand, those who wish to use flexible trusts or to make direct transfers to grandchildren would not be penalized. No matter how the assets are transferred, a transfer tax of roughly comparable magnitude would be collected once in each generation.

Of course, the proposed $1,000,000 exemption and the flat rate of tax mean that the system would not be perfectly neutral. Moreover, to avoid unfairness, the system has been designed so that in virtually every case the GST tax that would be imposed on a generation-skipping arrangement is less than the estate or gift tax that would be avoided. This means that some benefit from making generation-skipping transfers would remain in the system. It is impossible, however, to eliminate the residual benefit for generation-skipping transfers without reintroducing the scope and complexity problems that are present in current law. The proposal represents a reasonable compromise between the concerns of neutrality and effectiveness, on the one hand, and simplicity on the other. Most importantly, the proposal would introduce a degree of overall fairness that has heretofore been absent in the transfer tax system.

EXPAND CREDIT FOR TAX ON PRIOR TRANSFERS

General Explanation

Chapter 19.05

Current Law

If a decedent's estate includes property that was transferred to the decedent in the ten years preceding (or the two years following) the decedent's death and was the subject of an estate tax in the estate of the transferor, the decedent's estate is given a credit for the prior estate tax paid with respect to that property. The credit phases out over time, in two-year brackets. Thus, a full credit is given if the decedent dies within two years of the prior death, an 80 percent credit is given if the decedent dies more than two years but not more than four years after the prior death, and so on.

Reasons for Change

In certain situations, the current credit for tax on prior transfers is inconsistent with the rationale underlying the proposed tax on generation-skipping transfers, i.e., that the transfer tax ought to be imposed once per generation. For example, if A leaves property to his brother B, and if B dies more than two years after A, the property will be subject to more than one full estate tax in the generation of A and B. If B dies more than ten years after A, the property will be subject to two full estate taxes in that generation.

In many cases, A can avoid the necessity of a second estate tax payable at B's death by leaving the property in trust for B's benefit during his lifetime or by giving B a life estate in the property. Both these alternatives, however, require advance planning and entail administrative costs. More significantly, they place restrictions on B's use of the property that A may not wish to impose.

Proposal

In a case where a decedent's estate includes property inherited from a member of the same generation or a lower generation, a full estate tax credit would be given to the estate for any estate tax paid by the original transferor of the property. The credit would not phase out over time.

Effective Date

The proposal would apply to estates of decedents dying one year after enactment of the proposal.

Analysis

As with the proposal regarding the GST tax (Chapter 19.04), this proposal would make the transfer tax system fairer and a more neutral consideration for taxpayers in planning their estates. The system would be fairer because those taxpayers who wish to transfer property to a parent or sibling before the property passes to members of lower generations would not be penalized vis-a-vis the taxpayers who do not make such transfers and taxpayers who use trusts or life estates. The system would be more neutral because nontax considerations would generally determine the form of ownership for transfers of property.

REVISE RULES FOR INSTALLMENT PAYMENT OF ESTATE TAX

General Explanation

Chapter 19.06

Current Law

Payment of the estate tax can be deferred under two provisions of current law. Section 6161 gives the Internal Revenue Service the discretion to grant a one-year extension or a longer extension (up to ten years) upon a showing of reasonable cause. If the time for payment of estate tax is extended under this provision, interest on the tax liability must be paid at the generally applicable rate. Section 6166 allows the estate tax to be paid in ten annual installments beginning with the fifth year after the due date of the return in certain cases where a farm or closely held business comprises a substantial portion of the estate. Where section 6166 applies, the portion of the estate tax that can be deferred is limited to the portion attributable to the inclusion of the closely held business interest in the decedent's estate.

No showing of reasonable cause for the deferral is required under section 6166. In addition, the interest rate payable under that provision on the first $345,800 of tax (reduced by the unified credit) is four percent. Once the unified credit is fully phased in (in 1986), the amount of deferred tax eligible for four-percent interest will be $153,000. Interest on estate tax in excess of that amount is payable at the generally applicable rate.

Reasons for Change

The estate tax deferral provisions of current law need to be harmonized and modified to ensure that deferral is available only when appropriate. Clear standards should make it easy for taxpayers to determine when deferral is available and adequate interest on the deferred tax liability should always be charged.

In many cases, the provisions of section 6166 allow deferral of estate tax for a period longer than is warranted. Tax may be deferred even though sufficient liquid assets to pay the tax are on hand. These assets together with income of the estate may in fact be distributed to beneficiaries without accelerating the estate tax payment schedule.

Conversely, estates that do not meet the mechanical rules of section 6166 may be unable to obtain deferral under section 6161 for more than one year even though a longer deferral period may be justified. This uncertainty under section 6161 stems from the absence of any fixed rules for determining when the reasonable cause standard is satisfied.

Finally, the four-percent interest rate available under section 6166 for qualifying estates effectively reduces the estate tax burden on those estates with no tax policy justification. On the other hand, as long as the interest charge is adequate, it seems appropriate to allow deferred payment of estate tax under a fairly liberal standard.

Proposal

Section 6166 would be replaced with a provision that, when applicable, would allow all or a portion of the estate tax to be paid over a period of up to 15 years, with interest only for up to five years, and payment in ten annual installments thereafter. Eligibility would be based on the lack of cash or readily marketable assets that the estate has on hand, not on whether the estate holds assets of a closely held business. Interest on amounts deferred would be payable at the rate generally applicable to overpayments and underpayments of tax.

An initial one-year extension of time to pay the tax would be automatically available. Upon expiration of this period the amount of cash and readily marketable assets held by the estate would be determined. The amount of tax payable in installments would be the excess of the total estate tax liability over 75 percent of the estate's available cash and marketable assets. Administration expenses and debts of the estate paid prior to the determination date would therefore reduce the amount of available cash and make eligibility for deferral more likely. In addition, available cash would be reduced by any unpaid State or foreign death taxes. Cash and marketable property distributed to beneficiaries or converted into nonmarketable property would, however, be added back to cash on hand.

On each anniversary of the first determination date, the amount of available cash and readily marketable assets would be recomputed. Shortly after each such date, the estate would have to apply toward its tax and interest liability an amount equal to 75 percent of any excess of such amount over the highest amount of cash and marketable property previously remaining after payment of estate tax and interest. For example, if the estate previously had $100x in cash and had to pay estate tax of $75x, the amount of cash that would have to be used to pay tax on the next determination date would be 75 percent of cash in excess of the $25x that the estate had on hand. In order to ensure that the tax is eventually paid, however, at a minimum the estate would have to pay in each of the first five years the interest accrued on the outstanding estate tax balance, and, starting five years after the due date of the return, would have to pay principal in ten annual installments. This payment schedule is the same as that available to an estate that is currently eligible to defer all its tax under section 6166. Any payment in excess of this minimum would be credited against the minimum payment for the following year.

Cash and marketable property would include cash, deposits with financial institutions or mutual funds that are convertible into cash without substantial penalty, and any other personal property that is readily tradable (less any commission that would be due upon sale). Such property would not, however, include stock in a closely held business in which the decedent owned a ten percent or greater interest, even if such stock were readily tradable. Nor would property used in the conduct of a sole proprietorship (such as working capital) be included. Property held by an entity that the estate could cause to distribute such property and that was not reasonably necessary for the conduct of the business of such entity would be included in available property, but only if the value of such excess property exceeded five percent of the value of the assets of the entity in question.

If property other than marketable property were distributed to beneficiaries and were sold, the sales proceeds would be included in available property.

Section 6161 would be retained so that the Internal Revenue Service would continue to have the ability to grant extended deferral of tax in unusual circumstances. The one-year extension provided for in section 6161 would be made automatic.

Effective Date

The proposal would be effective for estates of decedents dying on or after January 1, 1986.

Analysis

The schedule for paying estate taxes should be more generous than that for paying income taxes because the estate tax is a one-time levy on property, not just on current income. Moreover, the risk that the tax will not be collected is relatively small, since there is a lien on assets of the estate until the Federal estate tax is satisfied.

Under the proposal, distributions would be indicative of the fact that the estate holds sufficient liquid funds to meet its obligations, including its Federal tax liability. This rule should not impose an undue burden on the estate beneficiaries. Indeed, a prudent executor may refuse to make any substantial distributions until the estate tax liability has been satisfied, even in the absence of the proposal. Although some estates may seek long deferral periods, there would be pressure on the part of the beneficiaries to close out the estate, particularly because distributions to beneficiaries would reduce the amount of tax that could be deferred. The charging of adequate interest would also give estates an incentive to satisfy the estate tax liability in a reasonable time.

Because a market rate of interest would be charged, this proposal should have no long-term effect on the present value of Federal estate tax receipts.

REPEAL ESTATE TAX DEDUCTION FOR INTEREST EXPENSE

General Explanation

Chapter 19.07

Current Law

The gross estate subject to the estate tax is reduced for necessary estate administration expenses that are allowable as administration expenses under the laws of the jurisdiction in which the estate is administered. Whether interest expense incurred by an estate can be deducted for estate tax purposes as a necessary administration expense is unclear in some cases.

Interest expense paid by an estate is generally deductible on the estate's income tax return for the year when paid. No income tax deduction may be taken, however, if the interest is deducted as an administration expense for Federal estate tax purposes.

Reasons for Change

Estate administration expenses are deductible for estate tax purposes because they are necessary costs incurred in passing property to the beneficiaries, and thus reduce the value of the estate to the beneficiaries. Interest expense accrued after the decedent's death differs from most major expenses of administering the estate in that it is a cost of carrying the estate's assets, which typically produce income for the estate or its beneficiaries. Such income is subject to the income tax, but is not included in the decedent's estate for estate tax purposes. Thus, interest is properly offset against income of the estate. Permitting the deduction for interest incurred by the estate, while not including the income produced by the estate, permits the estate tax to be artificially reduced.

Proposal

Interest would not be deductible for estate tax purposes as an administration expense.

Effective Date

The proposal would be effective for interest accruing on or after January 1, 1986.

Analysis

Denying an estate tax deduction for interest incurred after the decedent's death would make the estate tax more equitable and would simplify the determination of estate tax liability. Permitting the deduction reduces the effective estate tax rate for those estates that happen to be highly leveraged, even though the interest cost does not necessarily reduce the value of the assets passing to the estate beneficiaries. Allowance of an interest deduction on the estate tax return complicates the resolution of estate tax liability, because such liability may be successively adjusted downward as the estate pays additional interest. The resulting computation of tax liability can become quite complex.

Denying the estate tax deduction for interest cost is important in the context of the Treasury Department proposal to lower the marginal income tax rates. See Chapter 1.01. If the deduction were not denied, an estate could earn income taxed at a relatively low rate and deduct interest expenses against the higher estate tax rate. This type of tax arbitrage should not be permitted.

REVISE INCOME IN RESPECT OF A DECEDENT RULES

General Explanation

Chapter 19.08

Current Law

Section 691(a) of the Code governs the Federal income tax treatment of items of income in respect of a decedent (IRD). In general, IRD items include items of income that, as an economic matter, were earned or accrued by a decedent during lifetime but, under the decedent's method of accounting, were not properly includible by the decedent in computing taxable income prior to death. An IRD item is includible as income when recognized by the decedent's estate or by the beneficiary acquiring the right to the IRD item from the decedent.

The taxation of an item of IRD is intended to parallel the Federal income and estate tax consequences that would have resulted had the decedent received payment immediately prior to death. For estate tax purposes an item of IRD is includible in the decedent's gross estate at its fair market value without diminution for the income tax liability inherent in the right to the IRD. Section 691(c), however, provides a person recognizing IRD with an income tax deduction equal to the estate tax attributable to the inclusion in the decedent's estate of the "net value" of the item of IRD.

Deductions in respect of a decedent (DRD) consist of certain expenses that accrued during the lifetime of the decedent but were not properly deductible by the decedent under the decendent's method of accounting. Items of DRD are fully deductible when paid by the estate or, if the estate is not obligated to pay the item, by the person who, by reason of succeeding to the property of the decedent, succeeds to the obligation to make payment.

An item of DRD is fully deductible for estate tax purposes and generally is fully deductible for income tax purposes as well. No adjustment similar to the section 691(c) adjustment limits this double benefit for DRD items. Payment of a DRD gives rise to a double deduction except in cases where the DRD must be netted against IRD.

Reasons for Change

The double deduction generated by DRD items grants an undue benefit to estates that can take advantage of it and should be eliminated. The section 691(c) deduction is available only to taxpayers who itemize their deductions.

Proposal

The deduction allowed by section 691(c) would be replaced by a rule providing for a basis increase in each item of IRD equal to the estate tax liability attributable to such item.

Upon payment of an item of DRD, the income tax deduction otherwise allowable would be reduced by an amount equal to the estate tax savings attributable to the deduction of the liability for Federal estate tax purposes. The amount of estate tax savings would be computed in a manner similar to that utilized to compute the estate tax attributable to an item of IRD. Thus, the estate tax liability (including liability for State death taxes) would be computed with and without the deductions attributable to the items of DRD, with the difference allocated among each DRD item according to their relative amounts.

Effective Date

The proposal would be effective generally for items of IRD and DRD attributable to decedents dying on or after January 1, 1986. With respect to decedents dying prior to that date, the proposal would apply to items of IRD recognized and items of DRD paid on or after January 1, 1987.

Analysis

By providing for a basis increase rather than a deduction for estate tax attributable to an item of IRD, the proposal would simplify present law and treat all taxpayers (both itemizers and nonitemizers) equally. More important, by reducing the deduction allowable for items of DRD, the proposal would ensure that the payment of deductible expenses after the obligor's death would be treated no more favorably than payment prior to death.

LIMIT STATE DEATH TAX CREDIT

General Explanation

Chapter 19.09

Current Law

Present law allows a credit against Federal estate tax liability for the amount of any estate, inheritance, legacy, or succession taxes (i) actually paid by an estate to any State or the District of Columbia, and (ii) attributable to property included in the decedent's Federal gross estate. The maximum amount of this credit, which is generally referred to as the state death tax credit, is computed by reference to the decedent's taxable estate and a graduated rate table providing twenty separate brackets ranging from 0.8 percent to 16 percent.

Reasons for Change

The original purpose of the State death tax credit was to prevent States from competing with each other for high-income residents by having low (or no) State death taxes. Today, however, almost all States have enacted estate or inheritance taxes that provide significant revenue; arguably, therefore, the State death tax credit is no longer needed to prevent competition among the States for wealthy residents.

In its present form, the State death tax credit functions largely as a device for sharing Federal estate tax revenues with the States. This purpose can be served without the use of a highly detailed, graduated credit schedule.

Proposal

The present schedule setting forth the maximum state death tax credit would be replaced by a flat rate maximum credit equal to five percent of the decedent's Federal taxable estate.

Effective Date

The proposal would apply to estates of decedents dying one year after enactment of the proposal.

Analysis

The proposed change in the State death tax credit would not significantly alter the current level of Federal estate tax revenue sharing being provided by the credit. Use of a flat rate credit as the maximum instead of the twenty-bracket graduated schedule of present law would greatly simplify computation of the credit.

Moreover, setting the maximum credit at a flat rate would be more consistent with the limited progressivity of the present Federal estate tax rate structure.

REPEAL CAPITAL GAIN TREATMENT FOR REDEMPTIONS OF STOCK TO PAY DEATH TAXES

General Explanation

Chapter 19.10

Current Law

A corporate distribution in redemption of stock included in the gross estate of a deceased shareholder may result in capital gain treatment to the redeeming shareholder even if the distribution does not meet the capital gain requirements otherwise applicable in a redemption of corporate shares. The favorable treatment is limited to that amount of the distribution that does not exceed the sum of the estate, inheritance, legacy, and succession taxes paid by the estate and the funeral and administration expenses allowable in computing the taxable estate.

A redemption qualifies for the favorable income tax treatment only if the value of the decedent's entire stock interest in the corporation exceeds 35 percent of the decedent's adjusted gross estate. The decedent's estate may satisfy the 35 percent requirement by aggregating the stock of two or more corporations if the decedent has more than a 20 percent interest in each such corporation.

Reasons for Change

The adjusted basis for Federal income tax purposes of stock included in a decedent's estate will generally equal its fair market value on the date of death. Thus, a sale of those shares would not result in the recognition of gain or loss. The special redemption rules for qualifying stock held by estates permit estate taxes and administration expenses to be paid out of tax-free distributions of accumulated corporate earnings.

Proposal

The favorable treatment under current law for redemptions of stock to pay death taxes would be repealed.

Effective Date

The proposal would be effective for redemptions of stock included in the gross estate of decedents dying on or after January 1, 1986. A one-year delay in the effective date would be provided, however, for redemptions carried out pursuant to redemption agreements or shareholders' agreements that were binding on January 1, 1986.

Analysis

The special rules for redemptions to pay estate taxes may be defended as a method to prevent adverse income tax consequences where a decedent's estate has insufficient liquid assets to pay its Federal estate tax and expenses of administration, but does not qualify for the payment of estate tax in installments under section 6166. The proposal to liberalize the rules governing the payment of estate tax in installments described at Chapter 19.06 should eliminate those concerns. In addition, the proposal for dividend relief described at Chapter 7.01 would reduce the tax cost of corporate distributions. The proposal would result in similar distributions being taxed equally whether made before or after the death of the decedent.

CHAPTER 20

SIMPLIFY PENALTIES

General Explanation

Chapter 20.01

Current Law

The Internal Revenue Code contains a wide array of civil penalties for violation of its reporting and payment provisions. These penalties, set forth in over 75 different provisions, are intended to impress upon taxpayers the significance of their Federal tax obligations, to provide meaningful incentives for compliance and to compensate the United States for the expense of investigation and collection.

Penalties are imposed in addition to interest on deficiencies.

The penalty under current law for failure to pay taxes when due is .5 percent of the amount of the overdue tax per month, up to a maximum of 25 percent.

Reasons for Change

The penalty provisions under existing law are overly complex and often result in inconsistent treatment of similar violations. Penalties have been added piecemeal to the Code as new filing and reporting requirements have been legislated. The inconsistencies in the present penalty structure undermine horizontal equity among taxpayers and make the penalty provisions difficult to understand and administer.

The existing penalty for failure to pay taxes when due is overly burdensome, and generally falls on taxpayers whose failure to pay is not willful.

Proposal

The penalties relating to failure to file information returns, failure to furnish information, failure to provide information on a return, and filing false information would be consolidated into one provision with uniform penalties as follows:

(a) failure to file information tax return: $1,000 or 10 percent of gross proceeds required to be reported on the return, whichever is less;

(b) failure to file information statement: $50 for each statement;

(c) failure to furnish or provide data: $50 for each transaction;

(d) failure to supply information on return, statement, or document: $10 for each failure;

(e) filing incorrect information on a return or statement: $50 for each false statement;

(f) if any failure described in (a), (b), (c), or (d) above is due to intentional disregard of the filing requirement, then the penalty shall be 10 percent of the gross proceeds or other amount required to be reported on the return or statement with no maximum limitation, or $500, whichever is greater. If the filing of incorrect information in (e) above is intentional or due to reckless disregard of the truth, then the penalty shall be $500 per false statement.

All statutory maximum amounts on fixed dollar penalties would be eliminated. In addition, the present penalty for failure to pay taxes would be eliminated and replaced with a cost of collection charge.

Effective Date

The proposals would apply to taxable years beginning on or after January 1, 1986.

Analysis

The proposed restructuring of the penalty provisions should promote simplification in the administration of the penalty provisions and provide greater fairness in their application. The proposal would integrate many of the information reporting penalties into a single provision and provide uniform penalty amounts for similar reporting violations. Simplification of the penalty system also should promote compliance with the tax laws by enabling taxpayers to understand more easily the consequences of noncompliance.

The proposal imposes fixed dollar penalty levels for each category of information return violation. A higher penalty, based on the percentage of the unreported transaction, is imposed if the violation is willful rather than merely inadvertent or careless. Willful violations would involve deliberate, knowing or intentional disregard of filing or reporting obligations. If the heavier penalty is applicable for a willful violation, the notice and deficiency procedures generally applicable to ad valorem penalties would not apply.

The elimination of maximum penalty amounts would serve the interests of fairness and compliance. Maximum penalty amounts do not encourage compliance with the tax laws, nor do they promote uniformity of treatment among equals. There is no reason, for example, why an employer who fails to file 5,000 W-2 reports should receive relatively more favorable treatment than the employer who fails to file 50 or 500 such reports. Yet that is the result under current law, which imposes a statutory maximum on the penalty level of the larger employer.

U.S. GOVERNMENT PRINTING OFFICE : 1984 O - 459-813